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No. 01-1418

IN THE

Supreme Court of the United States

A. ELLIOTT ARCHER AND CAROL A. ARCHER,
Petitioners,

v.

ARLENE L. WARNER,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

PETITIONERS' REPLY BRIEF

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INTRODUCTION AND SUMMARY

Respondent offers two reasons for affirming the judgment below. In her lead argument, she notes that, as part of the settlement, petitioners voluntarily dismissed their state court fraud action with prejudice. She asserts that, under North Carolina law, this voluntary dismissal must be treated as if it were an actual adjudication of the merits of the fraud claim in her favor.

Respondent did not make this argument below or in her brief in opposition to the petition for certiorari. The argument is therefore waived. In any event, it is meritless. As we explain below, North Carolina follows the traditional rule that collateral estoppel extends only to issues that were actually litigated. No court has ever determined whether respondent committed fraud.

Respondent's second argument fares no better. She asserts that, in the settlement agreement, petitioners promised "that the issue of fraud will not be raised again." Resp. Br. 10. The agreement, however, does not say this. Rather, it includes a standard release of every "right, claim, or demand" relating to the state court fraud action, in exchange for a cash payment and a promissory note. J.A. 63, 67.

The agreement does not resolve one way or the other whether fraud occurred, and it is completely silent on the question of how the debt reflected in the promissory note would be treated in bankruptcy. Moreover, the agreement makes clear that the release of claims does not limit petitioners' rights under the promissory note in any fashion. Accordingly, when respondent filed for bankruptcy without having paid on the promissory note, petitioners were well within their rights under the settlement agreement to assert that the debt, reflected in that note, was not subject to the discharge in bankruptcy. Indeed, because the nondischargeability action seeks nothing more than to enforce petitioners' rights under the note, the releases cannot be understood to bar the action.

In sum, respondent has not offered any persuasive reason for frustrating the clear command of 11 U.S.C. § 523(a)(2), which provides that respondent's debt to petitioners is exempt from discharge if the debt is "for money . . . obtained by . . . actual fraud." *See Cohen v. de la Cruz*, 523 U.S. 213, 215 (1998) (holding that Section 523(a)(2)(A) "prevents the discharge of all liability arising from fraud"). This is true notwithstanding that the debt has been "liquidated," and its amount "fixed," in a settlement agreement. 11 U.S.C. § 101(5)(A). Like the settlement by consent judgment that was at issue in *Brown v. Felsen*, 442 U.S. 127 (1979), the settlement agreement in this case "should not bar further inquiry into the true nature of the debt" reflected in the agreement. *Id.* at 138. Instead, petitioners are entitled to prove in the bankruptcy court that respondent's obligation to them under the promissory note arises from fraud.

I. THE SETTLEMENT OF A FRAUD CLAIM DOES NOT RENDER DISCHARGEABLE AN OTHERWISE NONDISCHARGEABLE DEBT.

The question presented in this case is whether the settlement of a fraud claim bars petitioners from proving in bankruptcy that the debt reflected in the settlement is nondischargeable on account of fraud. The settlement agreement in this case is silent on whether there had been fraud, on any question of dischargeability, and on the parties' rights in bankruptcy. Nothing in the text of the Bankruptcy Code suggests that such a settlement agreement converts an otherwise nondischargeable debt into a dischargeable one.

A. The Court Of Appeals' "Novation" Theory Cannot Be Reconciled With The Text Of The Bankruptcy Code Or *Brown v. Felsen*.

As we demonstrated in our opening brief, the court of appeals' reliance on a "novation theory" to defeat the application of Section 523(a)(2) cannot be reconciled with the text of the statute, much less with the logic of *Brown v. Felsen*. Just as a party to an agreement for settlement and release of

claims is barred from suing for the original amount demanded, and may sue to enforce only the rights reflected in the agreement, a plaintiff who has won a judgment in a fraud action is barred by the doctrine of res judicata from suing on the underlying claim, and may sue only to enforce the judgment. In both cases, the prior debt has been "novated." That fact notwithstanding, *Brown* holds that Congress intended bankruptcy courts to undertake the "fullest possible inquiry" to determine whether a judgment was traceable to fraud. *Brown*, 442 U.S. at 138. The same reasoning applies to an obligation resulting from an agreement that settles prior claims arising from fraudulent activity. That such an agreement is a "novation" in the sense that it completely and forever releases the underlying prior claims is simply irrelevant to whether Section 523(a)(2) allows a creditor to prove to the bankruptcy court that the obligation reflected in the agreement is nondischargeable because it is traceable to fraud.

B. Paragraphs (11) And (19) Of Section 523(a) Undermine Respondent's Construction Of The Rest Of Section 523(a).

Respondent offers only one argument from the text of Section 523(a) for construing the statute not to apply to the promissory note obligation. This argument relies on two recent amendments to Section 523(a). These amendments, codified in paragraphs (11) and (19), expressly refer to certain debts reflected in settlement agreements. Because Section 523(1)(2) does not expressly mention settlement agreements, respondent suggests that Congress intended that parties are barred from showing that fraud debts reflected in settlement agreements are nondischargeable under Section 523(a)(2). Resp. Br. 28-30.

Correctly understood, however, the references to settlements in paragraphs (11) and (19) undermine respondent's construction of Section 523(a)(2) and provide additional support for the proposition that the form of a debt is generally irrelevant to whether it is dischargeable in bankruptcy. Pet.

Br. 13-14. Both provisions were meant to expand Section 523(a), and thereby to make it harder, not easier, for perpetrators of fraud to escape their obligations to their victims. In particular, both provisions were intended to relieve creditors of the burden of showing that debts reflected in certain types of settlement agreements are traceable to fraud. In effect, for purposes of showing nondischargeability, these provisions require "the bankruptcy court [to] give preclusive effect," in favor of the creditor, to, among other things, "non-court approved settlement agreements" that "would not be given preclusive effect under the common law." *Meyer v. Rigdon*, 36 F.3d 1375, 1380 (7th Cir. 1994).

This hardly implies, as respondent suggests, that other provisions of Section 523(a) do not apply at all to debts contained in or resulting from settlement agreements. Rather, a creditor who is owed a debt for fraud, reflected in a settlement agreement, but not falling within paragraphs (11) or (19) of Section 523(a), is required in a nondischargeability proceeding to prove that the debt is traceable to fraud.

Paragraph (19) of Section 523(a), enacted in recent months in response to a wave of securities fraud scandals,[1] was intended to relieve creditors who settle claims of securities fraud from needing to prove, in bankruptcy court, the underlying allegations of fraud. Paragraph (19) states that a debt is nondischargeable if it: (A) "arises under a claim relating to [securities fraud]," and (B) "results from" a judgment, consent order, administrative order, or "any settlement agreement entered into by the debtor."

Senator Patrick Leahy, the sponsor of the legislation, explained that the purpose of the provision was to relieve state regulators who settle claims of securities fraud of the burden they would otherwise face under Section 523(a) to "reprove"

[1] Paragraph (a)(19) was added to the Bankruptcy Code as part of the Corporate and Criminal Fraud Accountability Act of 2002, Title VIII of Pub. L. No. 107-204 (the Sarbanes-Oxley Act of 2002), § 803, 116 Stat. 745, 801.

their fraud cases in nondischargeability proceedings in bankruptcy court. "[S]ettlements may not have the same collateral estoppel effect as judgments obtained through fully litigated legal proceedings." 148 Cong. Rec. S1785, S1787 (daily ed. Mar. 12, 2002) (statement of Sen. Leahy). Under Section 523(a)(19), however, all that needs to be shown to establish nondischargeability is that a "claim" of securities fraud resulted in a settlement agreement. A creditor need not establish, as petitioners seek to in this case, that the debt is in fact traceable to fraud.

Paragraph (11) of Section 523(a), which was enacted in response to a series of failures of savings and loan institutions, has been construed to have a similar effect. It was intended to make it harder for those responsible for savings and loan losses to escape liability for their wrongdoing by filing for bankruptcy. *See* 136 Cong. Rec. H13288, 13289 (daily ed. Oct. 27, 1990) (statement of Rep. Brooks).

That paragraph renders nondischargeable any debt that is "provided in any final judgment" or "contained in any settlement agreement," and that arises "from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union." 11 U.S.C. § 523(a)(11). As the Seventh Circuit explained, prior to the enactment of paragraph (11), Section 523(a)(4) already prevented debtors from discharging any debt for money obtained by fraud or "for fraud or defalcation while acting in a fiduciary capacity." *Meyer*, 36 F.3d at 1380. Paragraph (11), therefore, "requires the bankruptcy court [to] give preclusive effect," in any nondischargeability proceeding, to default judgments and settlements that would not otherwise be sufficient, by themselves, to establish fraud. *Id.*

Respondent thus is incorrect to suggest that Congress enacted paragraphs (11) and (19) to "force debtors who wish to avoid nondischargeability to litigate a fraud allegation to its conclusion." Resp. Br. 29. To the contrary, these provi-

sions were enacted to enhance the rights of fraud victims who had settled. Specifically, they were intended to relieve such creditors of the burden, once a settlement had been reached, of having to litigate the question of fraud in a nondischargeability proceeding.

In any event, there are two additional reasons for rejecting respondent's argument that, because paragraphs (11) and (19) expressly refer to debts resulting from settlement, paragraph (2) must not apply to such debts. First, the argument is inconsistent with the text of the Bankruptcy Code. Section 523(a)(2)(A) applies to "any debt" "for money . . . to the extent obtained by . . . actual fraud." *See Cohen v. de la Cruz*, 523 U.S. 213, 218 (1998). A "debt" is defined as a "liability on a claim," 11 U.S.C. § 101(12), and a "claim," in turn, is defined broadly to mean a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." *Id.* § 101(5)(A).

The promissory note at issue in this case was "liquidated," and its amount "fixed," by settlement. *See Black's Law Dictionary* 411 (7th ed. 1999) (defining "liquidated debt" to mean "debt whose amount has been determined by agreement of the parties or by operation of law"). Petitioners' right to payment is therefore "a 'claim' giving rise to a debt." *Cohen*, 523 U.S. at 218 (internal quotations and citation omitted). Because the exception to discharge set forth in Section 523(a)(2)(A) applies to "any debt" arising from fraud, respondent's "full liability" traceable to fraud "falls within the exception." *Id.* at 218, 219. Respondent's inference from paragraphs (11) and (19), in addition to failing on its own terms, would thus conflict with these definitional provisions of the Bankruptcy Code. *See* Pet. Br. 13-14; U.S. Amicus Br. 10-13.[2]

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[2] *See also Cohen*, 523 U.S. at 221; *Grogan v. Garner*, 498 U.S. 279, 290 (1991) (citing *Brown v. Felsen*, 442 U.S. at 138).

Second, respondent's argument "proves too much." *Field v. Mans*, 516 U.S. 59, 67 (1995). Paragraphs (11) and (19) refer not just to debts reflected in settlement agreements, but also to debts that have been reduced to judgment. Paragraph (2) refers to neither. Respondent's argument would require the conclusion that paragraph (a)(2) does not even apply to judgment debts resulting from fraud, and that Congress intended to overrule *Brown v. Felsen* by enacting paragraphs (11) and (19). Such an improbable result, under which even a creditor who has litigated a claim of fraud to a judgment would be unable to maintain that the debt was nondischargeable, would vastly contract the scope of Section 523(a). That reading cannot be squared with common sense or Congress' avowed intent, in enacting paragraphs (11) and (19), to make it *harder* for debtors who have committed fraud to discharge their debts in bankruptcy.

II. A SETTLEMENT DOES NOT HAVE ISSUE PRECLUSIVE EFFECT UNLESS IT CLEARLY SHOWS THAT THE PARTIES SO INTENDED.

As noted in our opening brief, *Grogan v. Garner*, 498 U.S. 279 (1991), holds that when the question of fraud is litigated to a judgment, collateral estoppel principles apply in subsequent proceedings to determine the dischargeability of debts reflected in the judgment. Pet. Br. 4. When a case is settled rather than litigated to a judgment, however, the settlement ordinarily does not give rise to issue preclusion unless it is clear that the parties intended the settlement to have such an effect. Respondent's principal argument for affirming the decision below is based on her erroneous reading of North Carolina law as departing from this general understanding of the doctrine of collateral estoppel.

As noted above, respondent failed to make this argument in the courts below. This Court exercises its authority to consider such arguments "only in exceptional cases." *Heckler v. Campbell*, 461 U.S. 458, 469 n.12 (1983) (internal quotations and citation omitted). In addition, because this argu-

ment purports to present a basis to affirm the judgment below that would obviate the need to reach the question presented in the petition, it was incumbent on respondent to raise it in opposition to certiorari. *See* S. Ct. Rule 15.2 ("Any objection to consideration of a question presented based on what occurred in the proceedings below, if the objection does not go to jurisdiction, may be deemed waived unless called to the Court's attention in the brief in opposition."); *South Cent. Bell Tel. Co. v. Alabama*, 526 U.S. 160, 171 (1999).[3] In any event, the argument has no merit.

A. Because Settlements Are Not "Actually Litigated," They Do Not Have Issue Preclusive Effect Unless The Parties Clearly Intended It.

Respondent contends that the settlement in this case, which was accompanied by a dismissal of the claim "with prejudice," is tantamount to a determination on the merits in her favor on the issue whether fraud occurred. She further contends that such a "determination" is entitled to collateral estoppel effect. But under traditional principles of preclusion, a settlement is entitled to res judicata effect alone. Collateral estoppel applies only to matters that are "actually litigated." *See, e.g.*, Restatement (Second) of Judgments § 27 (1982) ("When an issue of fact or law is actually litigated and determined by a valid and final judgment, and the determination is essential to the judgment, the determination is conclusive in a subsequent action between the parties, whether on the same or a different claim."). Indeed, parties often settle

[3] If this question of North Carolina law has not been waived, it is more properly addressed in the first instance by the lower courts on remand, following a reversal of the court of appeals based on its erroneous construction of Section 523(a) of the Bankruptcy Code. *See Roberts v. Galen of Virginia, Inc.*, 525 U.S. 249, 253-54 & 253 n.2 (1999) (per curiam) (reversing and remanding without addressing alternative grounds for affirmance as to which certiorari had not been granted); *cf. Butner v. United States*, 440 U.S. 48, 58 (1979) (state-law questions are best addressed by "[t]he federal judges who deal regularly with questions of state law in their respective districts and circuits").

precisely in order to avoid the collateral estoppel consequences that would attach to a litigated judgment.

Accordingly, as a matter of "standard preclusion doctrine," "settlements ordinarily occasion no *issue preclusion* (sometimes called collateral estoppel), unless it is clear, as it is not here, that the parties intend their agreement to have such an effect." *Arizona v. California*, 530 U.S. 392, 414 (2000) (emphasis in original).[4] This rule applies regardless of whether the underlying lawsuit is dismissed "with prejudice," as it was here. *See Lawlor v. National Screen Serv. Corp.*, 349 U.S. 322, 327 (1955) ("It is of course true that the 1943 judgment dismissing the previous suit 'with prejudice' bars a later suit on the same cause of action. It is likewise true that *the judgment was unaccompanied by findings and hence did not bind the parties on any issue . . . which might arise in connection with another cause of action.*") (emphasis added); *United States v. International Bldg. Co.*, 345 U.S. 502, 506 (1953) ("A judgment entered with the consent of the parties may involve a determination of questions of fact and law by the court. But unless a showing is made that that was the case, the judgment has no greater dignity, so far as collateral estoppel is concerned, than any judgment entered only as a compromise of the parties.").[5]

[4] *See* 18A Charles Alan Wright et al., *Federal Practice and Procedure* § 4443 (2002) ("consent judgments ordinarily support claim preclusion but not issue preclusion"); 18 James Wm. Moore et al., *Moore's Federal Practice* § 132.03[2][h]-[i] (3d ed. 2002).

[5] Respondent cites *Matsushita Elec. Indus. Co. v. Epstein*, 516 U.S. 367, 385-86 (1996), for the proposition that "an express relinquishment of claims with prejudice[] satisfies the 'actually litigated' prerequisite to collateral estoppel." Resp. Br. 17. While *Matsushita* holds that a claim over which there is exclusive federal jurisdiction may be released in connection with a settlement of a state court lawsuit, nothing in *Matsushita* stands for the proposition for which it is cited by respondent.

B. North Carolina Follows Established Collateral Estoppel Principles.

Respondent errs in suggesting that North Carolina law departs from the general principles of collateral estoppel set forth above. To the contrary, "North Carolina currently recognizes [the doctrines of res judicata and collateral estoppel] in their traditional guise." *Thomas M. McInnis & Assocs., Inc. v. Hall*, 349 S.E.2d 552, 557 (N.C. 1986).[6] That includes the "actually litigated" requirement for collateral estoppel. *See, e.g., State v. Summers*, 528 S.E.2d 17, 20 (N.C. 2000) ("requirements for the identity of issues to which collateral estoppel may be applied" include requirement that "the issues must have been raised and actually litigated in the prior action").[7] As in other jurisdictions, the parties to a settlement in North Carolina can contract to ensure that their agreement

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[6] *See id.* (citing, *inter alia*, Restatement (Second) of Judgments § 27 (1982)); *State ex rel. Tucker v. Frinzi*, 474 S.E.2d 127, 128-29 (N.C. 1996) (quoting *Thomas McInnis & Assocs.*); 19 David E. Rigney, *Strong's North Carolina Index 4th* § 274 (Aug. 2002 update).

[7] *See also State ex rel. Lewis v. Lewis*, 319 S.E.2d 145, 148 (N.C. 1984); *Guilford County ex rel. Gardner v. Davis*, 473 S.E.2d 640, 642 (N.C. Ct. App. 1996) ("key question" in applying collateral estoppel "always concerns the issue(s) *actually litigated and decided* in the original action") (quoting *State ex rel. Lewis v. Lewis*, 303 S.E.2d 627, 630 (N.C. Ct. App. 1983) (emphasis in original), *aff'd*, 319 S.E.2d 145 (N.C. 1984)).

has issue preclusive effect.[8] Ordinary contract law principles apply in construing the terms of settlement agreements.[9]

The North Carolina decisions cited by respondent are not to the contrary. Respondent relies on five lower court decisions from the state for the proposition that the filing of a stipulation of dismissal with prejudice amounts to a "final judgment on the merits." Resp. Br. 16. But each of these decisions either undermines respondent's position or is simply inapposite.[10] Only two of the decisions actually apply collateral estoppel. One of these does not involve a settlement agreement or even a consent judgment;[11] the other case

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[8] *See Summers*, 528 S.E.2d at 20 ("[W]hen a fact has been agreed upon, or decided in a court of record, neither of the parties shall be allowed to call it in question, and have it tried over again at any time thereafter, so long as the judgment or decree stands unreversed.") (brackets in original; citations and internal quotation marks omitted); *Lewis*, 319 S.E.2d at 147; *see also Murakami v. Wilmington Star News, Inc.*, 528 S.E.2d 68, 70 (N.C. Ct. App. 2000) (because parties to contract are bound by its terms, collateral estoppel will bar litigation of issues "actually decided" during arbitration proceeding if agreement to arbitrate states that decision of arbitration panel is binding on contracting parties).

[9] *See Chappell v. Roth*, 548 S.E.2d 499, 500 (N.C. 2001); *id.* ("given the consensual nature of any settlement, a court cannot compel compliance with terms not agreed upon or expressed by the parties in the settlement agreement"); *cf. King v. King*, 552 S.E.2d 262, 264 (N.C. Ct. App. 2001) (consent judgment is a contract).

[10] Aside from the reasons discussed herein, the cases that involve a stipulation of dismissal may be inapposite for the reason that no stipulation of dismissal was filed in this case. The record contains a "notice of voluntary dismissal" filed by the plaintiffs "pursuant to Rule 41(a)" and signed by their counsel alone, J.A. 80, but no "stipulation of dismissal." *See* N.C. R. Civ. P. 41(a)(1) (distinguishing between notice of dismissal, filed by plaintiff, and stipulation of dismissal, signed by "all parties who have appeared in the action"); 2 G. Gray Wilson, *North Carolina Civil Procedure* § 41-2, at 34-35 (2d ed. 1995); *cf.* Fed. R. Civ. P. 41(a)(1) (drawing similar distinction).

[11] *See Miller Bldg. Corp. v. NBBJ N. Carolina, Inc.*, 497 S.E.2d 433 (N.C. Ct. App. 1998); *cf. Cudmore v. Howell*, 232 B.R. 335, 337

upholds the settled collateral estoppel principles explained above, *supra* at 8-11, by giving issue preclusive effect to a consent judgment that, unlike the settlement agreement in this case, expressly decided disputed issues.[12] The three remaining cases either use res judicata and collateral estoppel terminology interchangeably[13] or do not mention collateral estoppel at all.[14]

Respondent's cases amply confirm that "[t]he effect of a dismissal with prejudice is . . . to make the usual rules of res judicata applicable. " *Mumford v. Hutton & Bourbonnais*

(E.D.N.C. 1999) (giving collateral estoppel effect to default judgment entered after settlement negotiations fell through), *cited in* Resp. Br. 18.

[12] *NationsBank v. Am. Doubloon Corp.*, 481 S.E.2d 387, 391 (N.C. Ct. App. 1997) (stating that consent judgment, "having disposed of the issue of the value of the property, is binding upon the parties herein" where consent judgment specifically granted defendants credit of $30,000 for value of property); *id.* at 392-93 (consent judgment, which "expressly provided" for creditor's sale of collateral within thirty days after entry of judgment, "was a final judgment as to the issue" of commercial reasonableness of creditor's retention of collateral to date of entry of judgment); *id.* at 389 (describing issues resolved in consent judgment).

[13] *Caswell Realty Assocs. I, L.P. v. Andrews Co., Inc.*, 496 S.E.2d 607, 610, 611 (N.C. Ct. App. 1998) (after stating that "dismissal with prejudice is an adjudication on the merits and has res judicata implications," concluding that "there has been a sufficient identification of the causes of action in [first action] and the instant case so as to call the doctrine of res judicata and/or collateral estoppel into play") (citations omitted); *cf. NationsBank*, 481 S.E.2d at 393 ("res judicata and collateral estoppel"; "res judicata and/or collateral estoppel").

[14] *Barnes v. McGee*, 204 S.E.2d 203, 205 (N.C. Ct. App. 1974) (dismissal with prejudice, "unless the court has made some other provision, is subject to the usual rules of res judicata") (quoting Wright and Miller); *Bailey v. Gitt*, 518 S.E.2d 794, 796 (N.C. Ct. App. 1999) (voluntary dismissal rendered appeal moot; no mention of res judicata or collateral estoppel). *Cf. Nash County Bd. of Educ. v. Biltmore Co.*, 640 F.2d 484, 486-87 & 487 n.5 (4th Cir. 1981) (applying federal law of res judicata, but noting that "North Carolina law gives res judicata effect to consent judgments"), *cited in* Resp. Br. 16.

Co., 267 S.E.2d 511, 514 (N.C. Ct. App. 1980).[15] They do not show, however, that North Carolina gives issue preclusive effect to settlement agreements.

III. NOTHING IN THE SETTLEMENT PURPORTS TO RESOLVE THE QUESTION WHETHER FRAUD OCCURRED, TO RESOLVE QUESTIONS OF DISCHARGEABILITY, OR TO LIMIT PETITIONERS' RIGHT TO PAYMENT UNDER THE PROMISSORY NOTE.

Nothing in the settlement agreement in this case addresses the question whether fraud, in fact, occurred. Nor does the settlement purport to resolve whether the debt reflected in the note is dischargeable. Instead, the settlement agreement—which does not even mention bankruptcy, much less provide for the parties' rights in the event of a bankruptcy—reflects the parties' intent to leave the merits of the fraud allegation unresolved. Even more tellingly, the agreement and its accompanying releases expressly protect, rather than impair, petitioners' rights to collect the $100,000 due to them under the promissory note given as consideration for the releases.

A. The Settlement Agreement Is Silent As To Whether Fraud Occurred.

Contrary to respondent's assertions, nothing in the settlement agreement can be read to determine that the underlying allegations of fraud were false. Rather, the agreement is silent on that question.

Under the terms of the releases, petitioners gave up their right to bring suit against respondent for fraud, in exchange

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[15] *See* 2 G. Gray Wilson, *North Carolina Civil Procedure* § 41-4, at 41-42 (2d ed. 1995) (if dismissal pursuant to N.C. R. Civ. P. 41 "is with prejudice," it "preclud[es] further litigation under the doctrine of res judicata"); *Kabatnik v. Westminster Co.*, 306 S.E.2d 513, 515 (N.C. Ct. App. 1983) ("For purposes of res judicata, a voluntary dismissal with prejudice is an adjudication on the merits in favor of the opposing party.").

for a promissory note. The parties thus agreed that the dispute between them would be resolved without either side obtaining a judicial determination on the merits, one way or the other. J.A. 67 ("No party admits any liability or wrongdoing whatsoever in signing this agreement."). The agreement does not by its terms address the treatment of petitioners' claim in bankruptcy, and nowhere limits petitioners' right to contend that the debt reflected in the note would be nondischargeable.

Nothing in the agreement prevents petitioners from now arguing, in an effort to collect on the promissory note, that the debt reflected in that note is traceable to fraud. The agreement documents released respondent from "rights," "claims," and "demands." J.A. 67, 70. The assertion of nondischargeability, however, is none of these things. If it were, then such a "right," "claim," or "demand" would be barred, after a judgment, from being asserted under the doctrine of res judicata. As this Court held in *Brown*, however, nondischargeability is simply a response to the "defense of bankruptcy" asserted by respondent. *Brown*, 442 U.S. at 133.

Respondent's argument thus depends on construing the language of the settlement agreement to bar petitioners not merely from asserting "rights," "claims," and "demands" of fraud, but from making even *allegations* of fraudulent or other bad conduct. To this end, respondent uses the term "claim" interchangeably with "allegation" (and with "assertion," "contention," and "issue"). *See, e.g.*, Resp. Br. 1, 2, 10, 19, 24, 27, 31, 37.

To suggest that the settlement resolves "allegations" rather than "claims," however, is simply another way of saying that the settlement agreement deserves collateral estoppel effect in favor of respondent on the question whether fraud was committed. As is explained above (*supra* at 7-12), the general rule, and the governing law in North Carolina, is that while a settlement is entitled to res judicata effect, a settlement agreement does not receive collateral estoppel effect (either in favor of the plaintiff or of the defendant) as to any

underlying factual allegation unless the clear and expressed intent of the parties is that the agreement is to have such an effect. The application of this principle in this case is clear: because the settlement agreement before this Court does not contain any indication of such an intent, the agreement does not have any collateral estoppel effect. Although the settlement agreement contains a broad general release of claims, nothing in the agreement suggests that the parties intended it to have a broader issue preclusive effect.

B. The Agreement Does Not Limit Petitioners' Right To Payment Under The Promissory Note.

The settlement documents expressly carve out respondent's promissory note obligations from the releases. *See* J.A. 61-72. Because the nondischargeability action seeks nothing more than to enforce petitioners' rights under the note, the releases cannot be understood to bar the action. Petitioners are not asserting any claim against respondent that they gave up under the settlement agreement.

Indeed, the only "claim" at issue in this case is the "right to payment," 11 U.S.C. § 101(5)(A), that petitioners hold under the promissory note.[16] By contesting dischargeability in federal court, *see id.* § 523(c)(1), petitioners are simply protecting this claim using the tools that bankruptcy law affords to victims of fraud and other persons benefited by Section 523(a). Nothing in the settlement agreement or releases even mentions—let alone waives—petitioners' right under federal bankruptcy law to contest the dischargeability of respondent's promissory note debt in a hypothetical future bankruptcy proceeding.[17]

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[16] *See Cohen*, 523 U.S. at 218 ("right to payment" in this sense means "enforceable obligation") (quoting *Pennsylvania Dep't of Pub. Welfare v. Davenport*, 495 U.S. 552, 559 (1990)).

[17] *Cf. Brown*, 442 U.S. at 137 (rejecting debtor's contention that if creditor had wanted to preserve objections to dischargeability for bankruptcy court review, creditor should have bargained prior to bankruptcy

Respondent thus misses the mark when she argues that a ruling in favor of petitioners would make it "impossible" for fraud defendants to settle because they could never be sure that released claims of fraud would not be resurrected and litigated in a subsequent nondischargeability proceeding. Resp. Br. 27. Petitioners are not asking this Court to resurrect any claim that they released in the agreement. While the state court complaint described damages that far exceeded the $300,000 agreed to in the settlement, J.A. 34-60, petitioners do not contend that they are entitled to assert a claim for this larger amount. Rather, petitioners assert only their right to receive payment on the $100,000 note that was given to them as part of the settlement, which right is subject to no release. Respondent's various arguments regarding the importance of settlements in the bankruptcy process, Resp. Br. 25-30, are simply misplaced.

IV. EVEN IF THE PARTIES HAD AGREED TO SETTLE THE ISSUE OF DISCHARGEABILITY, SUCH AN AGREEMENT MUST BE DISREGARDED AS INCONSISTENT WITH THE BANKRUPTCY CODE.

Even if the parties had agreed in the settlement to resolve questions of nondischargeability, such an agreement would have to be deemed unenforceable as inconsistent with bankruptcy law and policy.

Respondent has not overcome the rationale advanced in our opening brief for invalidating settlement provisions, entered into before bankruptcy and therefore without notice to creditors or bankruptcy court approval, that use prebankruptcy assets to purchase postbankruptcy benefits for prospective debtors. If such provisions were enforceable, prebankruptcy bargaining to purchase such provisions would inevitably diminish the pool of assets that would otherwise

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for stipulation that consent judgment resulting from settlement did not resolve issues of dischargeability under bankruptcy law).

be available to third-party creditors who were not parties to the negotiation of the provisions and who lacked an opportunity to object to them. Pet. Br. 24-27. To prevent a debtor from "externalizing" the costs of purchasing dischargeability by shifting those costs to absent third-party creditors, such provisions should be enforceable only if made or approved *after* a bankruptcy filing, subject to the requirements of notice to creditors and bankruptcy court approval.

Respondent points out that settlements, both prepetition and postpetition, are essential to the orderly operation of the bankruptcy process. This is certainly true. As the Advisory Committee Note to Bankruptcy Rule 4004(c) indicates, *see* Resp. Br. 25, questions of the dischargeability of debt are commonly settled during the course of a bankruptcy case, on notice to creditors. Respondent is also correct to assert that a creditor is entitled to forgo an assertion of nondischargeability—an act that, by itself, does not impair the rights of any other third-party creditors of the bankruptcy estate. *Id.* at 32. But neither of these situations gives rise to the problem present in a prepetition settlement releasing a creditor's right to assert the nondischargeability in bankruptcy of a prebankruptcy debt: the imposition of costs on third-party creditors without affording the creditors notice and an opportunity to be heard.

By the same token, prepetition settlements that liquidate disputed claims, but do not purport to resolve questions of dischargeability (such as, for example, the settlement agreement in fact reached in this case) are also commonly enforced. *Id.* at 26. In such settlements, no party has an improper incentive to obtain a personal benefit at the expense of an absent third party.

A settlement agreement reached prior to bankruptcy that purports to resolve questions of dischargeability is quite different from these other types of settlements that play a central role in any bankruptcy case. If a disputed claim is being liquidated, and the debtor is *also* obtaining a discharge of oth-

erwise nondischargeable debt, it follows as a simple matter of logic that the amount of the creditor's newly liquidated claim will be greater than it would have been had the claim been liquidated in a way that did not also involve a resolution of the nondischargeability question. Whenever that occurs, the value of the claims of other creditors will necessarily be diluted. Although it is true that the most egregious examples of such action may be redressable by suit against the creditor on a fraudulent conveyance theory, the far more sensible rule would be to subject any settlement involving rights that are unique to bankruptcy—such as questions of dischargeability—to the scrutiny of the bankruptcy court.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed.

Respectfully submitted,

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